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General Business Conditions

THE steel mills resumed operations quickly after the Supreme Court, on November 7, upheld the federal court order sending the men back to work. By the end of the month steel ingots were being produced at a rate of 92 per cent of calculated capacity. While grumbling about "slave labor" and threatening to resume the strike when the injunction expires on January 26, the men generally pitched in willingly and, with their wives and families, looked forward to a resumption of the flow of fat pay checks.

Disruptions caused by the strike will take time to repair, even if, as everyone can hope, an amicable settlement is reached by January. Nevertheless, as the million persons out of work because of the steel strike return to their jobs, the prospects favor rising income and spending in the months ahead. Retailers are counting on another record Christmas season.

It will be some time, of course, before a balanced, orderly flow of finished steel, in the multitudinous forms required by industry, is achieved, and still longer before inventories are brought into balance. Steel stocks — abnormally swollen before the strike — have dwindled almost to the vanishing point. Thus, there is a scramble for steel, not only to meet heavy current demand but also to build up adequate working stocks to ensure steady operations.

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Persisting Shortages

Just as the steel shutdown had a delayed impact on metal-fabricating industries, the resumption of operations will benefit them only after some delay. Not until the closing weeks of the strike were metalworking industries seriously affected, but then layoffs mounted rapidly. In many cases, to keep final assembly lines going as long as possible, supply pipelines were drained of parts and components.

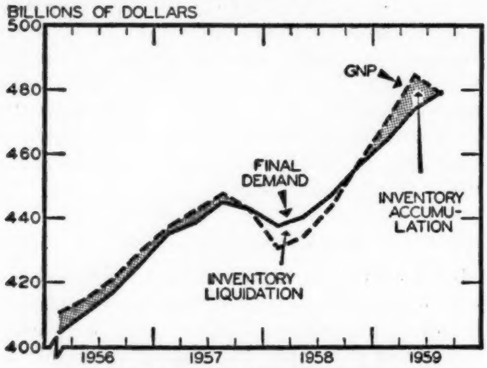
Thus, paradoxically, automobile plants were still laying off assembly line workers during November. General Motors, while recalling employees at plants making parts, completely shut down its passenger car assembly lines on November 11 and will not get going again until December 7 or later. *Ward's Automotive Reports* estimates that three quarters of a million cars will have been cut from fourth quarter production schedules because of steel shortages, placing the latest estimate for 1959 domestic passenger car production at 5.5 million units. Output in 1960 will be boosted to recover as much of this loss as possible. Meanwhile, waiting lists are building up for the new cars, which have had a good initial reception.

On the whole, industrial production, as measured by the Federal Reserve index (seasonally adjusted, 1947-49 = 100), held relatively steady from August to October. From the prestrike record of 155 in June, the index declined less than 5 per cent. Because of the crosscurrents in

durable goods output, it is not clear how much — if any — recovery the November index will show. By December, however, industrial activity should be on its way back to prestrike levels.

Inventory Fluctuations

Final demand — purchases of goods and services by consumers and government and capital investment by business — continued to rise steadily through the third quarter, virtually unaffected by strikes. The accompanying chart shows the behavior of final demand with the effects superimposed of inventory liquidation or accumulation on the gross national product.



Gross National Product, Inventory Changes, and Final Demand, 1956-59
(Seasonally Adjusted Annual Rates)
Source: U.S. Department of Commerce.

The gross national product, up to a seasonally adjusted $484.5 billion in the second quarter and clearly headed toward $500 billion, slipped off to an estimated $478.6 billion in the third quarter as a result of strike disturbances, which eliminated the plus influence of inventory accumulation. Businessmen were adding to stocks at a $10.4 billion annual rate in the second quarter, but in the third they reduced them at a $1 billion rate. This shift in inventory demand more than accounted for the decline in gross national product. Clearly, the rebuilding of inventories will add to the sharpness of the upswing in early 1960 as it did in early 1959.

Expenditures for home building declined slightly in the third quarter as tight money and shortages of steel for apartment building held back construction. Further declines are in prospect, judging by the 11 per cent drop in the rate of privately-financed housing starts in October. However, the third quarter slippage in housing activity was offset by increasing work on industrial, commercial, and other private nonresidential projects. These offsetting movements, which are expected to continue in the year ahead, demonstrate the constant shift of financial and material resources which takes place in a dynamic, high-level economy.

The Key to Growth

A survey taken in October by McGraw-Hill showed that at that time manufacturers were planning to boost their plant and equipment spending in 1960 by 19 per cent over 1959. Nonmanufacturing firms expected to increase capital expenditures 6 per cent to a new record. At the time of this survey, the steel strike clouded the outlook with uncertainty, particularly construction schedules and delivery dates on heavy equipment. Consequently, a tendency toward understatement of anticipated expenditures would be only natural. Furthermore, in past periods of widespread improvement in economic activity, business has tended to raise its sights on plant and equipment spending. Prospects that dislocations of the strike will be corrected and that business will be on the upgrade next year make it more than likely that business will boost capital spending budgets for 1960 still further.

Capital investment paves the way for future increases in production and productivity and thus is the key to real economic growth. Businessmen's willingness to maintain a high level of plant and equipment outlays is, of course, fostered by an economic climate in which they feel able to operate peaceably and profitably. These are investments for progress in the true sense of the word. To finance them will require profits running beyond the old peak set in 1956.

Specifically in the steel industry, leaders are looking forward to a record-breaking performance, including needs for rebuilding inventory. Republic Steel's president, T. F. Patton, has estimated the demand for steel in 1960 in excess of 135 million ingot tons. This would substantially exceed the 1955 record of 117 million tons.

Labor Demands and Investment

All the rosy optimism for 1960 hinges on willingness of people to accept prosperity and stay at work. In the steel business one might suppose that the men, after business recession losses in 1958 and strike losses in 1959, might be ready to enjoy a bonanza year. The quest for full employment has many obstacles and one of these is the tendency of the workman to demand more than the traffic will bear when jobs are indeed plentiful.

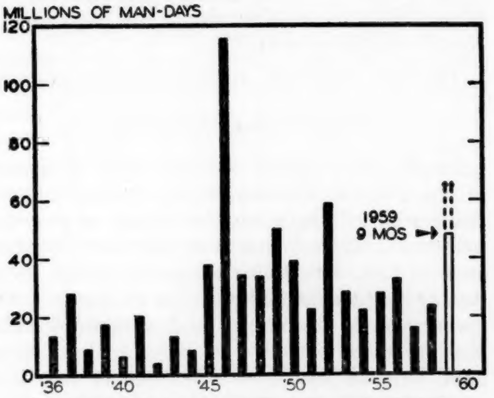
The big cloud ahead is labor unrest. The outcome of negotiations now in progress may have

an important bearing on the ability of the economy to capitalize on the markets of the "Fabulous Sixties" and to realize its full growth potential. In one recent union-management dispute after another, the crucial issue has turned out to be working rules and the right of management to promote efficiency and cut costs.

If a businessman is not able to obtain the cost reductions he expected from an expensive piece of new equipment, or if the efficient scheduling of his operations is repeatedly disrupted, his incentive to make further investments of this sort is greatly diminished. The investment climate for the steel industry is certainly not enhanced by union insistence on work rules which perpetuate outmoded "past practices." The railroads' plight is not remedied by rules encouraging "featherbedding," nor does dock union opposition to new cargo-handling techniques speed the prospect of substantial investment in automation. Investment decisions in firm after firm may depend on the attitude toward cost cutting and technological improvements which emerges from current negotiations. Yet these investments, and more efficient utilization of manpower, are the very means to the progress everyone wants.

Strike Losses

The economy has been disrupted by strikes this year to the greatest extent since 1946. In the first three quarters of 1959, a total of 48,500,000 man-days was lost through work stoppages, with time lost in the steel and dock strikes during the fourth quarter pushing the year's total beyond 1949 and 1952. And these calculations simply include time lost by strikers and ignore people laid off as a secondary result.



Man-days Idle Because of Work Stoppages, 1936-59

A thorny problem is how, in a free society, to get people to work. The Taft-Hartley Act has been condemned as "a slave labor law." Yet it does not force anyone to work in a steel plant. Its procedures can, however, limit the rights of a union organization to shut down a vital industry. These rights, already denied to public employees in various jurisdictions, stand on trial in the court of public opinion.

The workings of the Taft-Hartley Act give workers an opportunity to register their willingness to continue the strike. Sixty days after the injunction is issued (January 6 in the case of steel) the board of inquiry appointed by the President reports its findings in the case, including the details of management's last offer. During the next 15 days (by January 21), the National Labor Relations Board takes a secret ballot of all employees involved. If no agreement is reached within five days after the results are made public, the injunction is dissolved and the union is free to strike again. In the dock dispute, also currently under a Taft-Hartley injunction, a renewed strike is possible by December 27.

Some doubts have been expressed as to the workability of the election provisions. Many union members, who might be glad indeed to remain at work, presumably would be restrained from voting to accept management's last offer on the ground that they would be weakening their union. Yet it would be a constructive achievement if the procedure could be made to work and spare the Congress from seeking alternatives. One thought that needs to be borne in mind in any consideration of the problem is that there must be hundreds of thousands of men who would be glad to work in steel plants at present steel wages if union pressures did not deter them.

Latest Offer

In mid-November, steel management liberalized its offer to 30 cents an hour in wages and fringes over a three-year period plus cost-of-living raises of up to 8 cents in the second and third years of the contract. It proposed submitting the controversial work rules issue to a two-man labor-management committee for study and recommendations; if agreement is not reached by June 30, 1960, the issue would go to arbitration. R. Conrad Cooper, chief negotiator for the industry, characterized the terms as "a fair offer to do what can be done and still keep within noninflationary bounds in the cost of steel production." David McDonald, president of the United Steelworkers, who earlier had proclaimed that management would get work rule changes "over our dead bodies," calculated the offer as worth only 24 cents an hour.

Various suggestions have been made for government intervention in the event that steelworkers go out on strike again. It is unlikely that industry will be able to do much steel inventory building before the injunction period ends, and the nation's health and safety may be as much in peril as they were when President Eisenhower first requested the injunction on October 19. The dangers in relying on government action to settle labor disputes were ably pointed out by Secretary of Labor James P. Mitchell back in April:

> Ultimately, if enough decisions are taken out of the hands of both the workers and the employers, the Government assumes the responsibility for finding just solutions. What may follow is that Government finds itself setting wage scales, fixing prices, profits and the conditions of work, determining hours, hearing grievances, and throwing its weight around in other private matters.
>
> This should be especially significant to a society like ours that is rooted in free institutions. We have to consider and preserve the freedom of negotiation and agreement.
>
> This freedom depends upon its responsible exercise. Labor and management have an obligation to work toward settlements fairly and objectively, in full possession of the facts. They must recognize that they are not alone at the bargaining table: the customer, the public, is also there.
>
> The peaceful settlement of negotiations is one measure of labor-management progress, but is meaningful *only* if achieved with full recognition of the public interest in the growth of our economy and in stable prices.

Price Stability and Growth

It has become commonplace to say that gradual, creeping inflation is a necessary companion of rapid growth. Even people who recognize the evils of inflation wonder if price stability can be achieved only at the cost of checking economic growth. Last July, at the United Nations Economic and Social Council, U.N. Secretary General Dag Hammarskjold asked whether the economically developed nations are not paying too much attention to the dangers of price inflation and too little to needs for economic growth: "Are we not, perhaps, rather inclined to resolve the conflict between stability and growth too exclusively in favor of stability — to the detriment of the vigor and dynamism so characteristic of the world economy during the first postwar decade?"

Replying to Mr. Hammarskjold, M. Roger Auboin, former General Manager of the Bank for International Settlements and the French representative to the Council, gave the other side of the argument, citing France's experience with the measures President de Gaulle introduced at the end of 1958 to achieve financial stability after many years of chronic inflation:

> The reforms have not accentuated the slowdown in business; quite contrary, they have brought about a recovery, which is now unmistakable. . . . An entirely new situation has thus emerged in France — a situation eminently favorable to vigorous expansion. This will enable my country to keep its place among other industrial nations that are now resuming their march forward.

Another vote for price stability came from Karl Blessing, president of the German central bank, at the World Bank and Fund meetings in October:

> We have listened with some surprise to discussions that conveyed the impression that there might be a possible conflict or even an incompatability between a policy of monetary stability and a policy of economic growth.
>
> In our minds there is no doubt whatsoever that there is no conflict between stability and growth. And even more, we are firmly convinced that stability is one of the main prerequisites of sustained growth.
>
> This conviction is based on theoretical considerations as well as on experience. Germany's postwar development, in my opinion, shows clearly that a policy of monetary stability pays good dividends in economic growth.

Inflation provides an insecure basis for growth. All history shows that it never goes on forever. As Dr. Per Jacobsson, Managing Director of the International Monetary Fund notes, inflationary methods of finance do not provide a durable basis for sustained growth. Reliance on them "is bound sooner or later — and often sooner rather than later — to result in a monetary crisis."

It is better to forestall crisis and knock out the disease. But even this can be painful. Dr. Jacobsson points out that "the implementation of a stabilization program designed to eliminate inflation will almost inevitably be followed by a period in which certain hardships are experienced, and the rate of economic expansion somewhat reduced." Thus, drastic retrenchment becomes the price paid to create the basis for resumed healthy growth.

The best thing is to avoid the disease entirely.

The Enemy of Growth

Dr. Winfield Riefler, assistant to the chairman of the Federal Reserve Board, spelled out the reasons why "inflation is the enemy of growth" before a Stanford University Business Conference in July. Dr. Riefler pointed out that inflation aggravates instability in the economy: overspeculation in inventories and premature additions to plant capacity, in order to beat price rises, have an inevitable aftermath of recession as inventories are cut back and excess plant capacities become widespread.

Moreover, Dr. Riefler added, inflation and the expectation of inflation "impair the quality of

management investment decisions and thus promote the misallocation of capital." As a result, nations get "less growth per dollar of investment" in inflationary periods. The best choice between competing ways of producing things is harder to make when costs of materials and labor are moving up rapidly and erratically. In countries in which inflation has become a way of life, misallocation of capital is worst: badly needed savings are used to bid up the prices of inflation hedges such as real estate rather than for productive investment.

Dr. Riefler stressed the adverse impact of inflation on savings, which are essential to growth since they finance the tools and plants needed for bigger and more efficient production. People fearful of inflation use their savings to buy common stocks or land in the hope that these will rise in price with the general price level. Thus, there is less money available for loans to finance business, home building and government. Savings may actually be reduced if buoyant markets and resulting big capital gains on stocks and real estate make people feel rich and inclined to spend more on consumption. When inflation is really rampant people refuse to save, spending money as fast as they get it. In this sort of atmosphere orderly planning for expansion is impossible. No one can forecast what costs will be or whether sufficient funds can be raised.

At the same time inflation encourages people to borrow in advance to buy houses, household equipment, and the like, in the thought that prices are going up and repayment can be made in cheaper dollars. In light of current controversy over interest rates it is interesting to note Dr. Riefler's comment that "in practice, the rate at which borrowing to acquire inflation-resistant real assets has been profitable has proved all too frequently to be much higher than 6 per cent."

Inflation finally brings a balance of payments crisis. Rising costs price a nation's wares out of world markets at the same time that inflated money incomes increase demands for imported goods. For a time gold and foreign exchange reserves can cover essential import requirements, but the point comes where the danger of devaluation drives money out of the country, taking away essential credit supply and sending interest rates still higher.

U.S. Economic Growth

It is often overlooked that the United States recorded one of the most rapid growth periods in its history during the almost thirty years of declining prices which followed the Civil War. Production approximately tripled from 1869 to 1896 while prices were declining 29 per cent. According to studies made by Professor Simon Kuznets at the National Bureau of Economic Research, U.S. gross national product — total goods and services produced, measured in constant dollars — rose 4.9 per cent a year, compounded, within this period. Net capital formation — additions to the nation's plant and equipment which are the foundation of future growth — increased 5.7 per cent a year. This experience refutes the idea that inflation is the essential medicine for growth.

Secretary of the Treasury Robert B. Anderson has cited the evidence of later periods:

> From 1910 to 1915, for example, manufacturing production increased 30 per cent, while prices showed a moderate decline. During the decade of the Nineteen Twenties, we had one of the most notable periods of sustained economic growth in the history of our country prior to World War II, with national output rising 50 per cent in eight years. And yet this decade was characterized by remarkable price stability. Between 1951 and 1955, a period again characterized by relative stability in the broad indexes of wholesale and consumer prices, we reached the most prosperous levels attained in our economy up to that time.

The fact is that, as Secretary Anderson put it, most of the price inflation in U.S. history has been the accompaniment or aftermath of war. Our experience in periods uninfluenced by war emergencies demonstrates that growth goes hand in hand with relatively stable prices.

Neil H. Jacoby, Dean of the UCLA Graduate School of Business, summed up the record in July before a Life Insurance Symposium in New York:

> . . . most thoughtful Americans have come to this conclusion: If individual prices and movements of capital and labor are flexible, as a result of adequate competition in open markets and an absence of governmental interference with farm and other prices, then the real growth of the United States' economy is fostered by a dollar of stable value. Even a gradual inflation of the price level, once it becomes generally expected, impedes real growth. It results in lessened saving, misdirected investment, speculation, looser management, and lower productivity. When people expect long-run stability in the price level, their behavior promotes the growth of production.

The Record of Experience Abroad

Postwar experience abroad tends to support the view that inflation acts more as a drag on growth than as a stimulant. In Europe, the most striking production achievement — the "German miracle" — was based on adherence to old-fashioned policies of free markets and financial

orthodoxy. On the other hand, a number of nations which were more indulgent of inflation had smaller increases in production. But, as time passed, the whole of Europe has come to recognize the importance of curbing inflation for sounder growth.

It is often asserted that inflation is inevitable, and even helpful to growth, in the economically underdeveloped nations. To test this contention, the Federal Reserve Bank of New York, in an article "Inflation and Economic Development" in its August 1959 *Monthly Review*, has compared economic growth from 1950 to 1957 in sixteen underdeveloped nations: eight with relatively stable prices and eight with rapidly rising prices. After cautioning that such international comparisons are difficult because data often are not strictly comparable, the Bank asserts that the principal generalization suggested by its study is that "while stable prices tend to promote an orderly and fairly rapid expansion in output, inflation tends to lead to uneven and, in many cases, lagging rates of over-all growth:"

> . . . the countries where prices advanced moderately or not at all from 1950 to 1957 . . . experienced rates of economic expansion which by and large were steady and which clustered around an average of close to 6 per cent annually. In contrast, the countries where sustained inflationary pressures developed during this period have shown widely varying and somewhat sporadic growth; the average rates of growth have ranged from less than 1 to more than 7 per cent, with an average of about 4 per cent for the whole group.

The Bank points out that in nations with rapid price increase – including Chile, Bolivia, Argentina and Thailand – mounting inflationary pressures were accompanied by lagging output. In some years, output actually declined in the face of rapidly rising prices. For the period as a whole, Brazil and Turkey achieved vigorous rates of economic expansion despite fairly intense inflationary pressures, but only at the cost of incurring considerable foreign indebtedness. In Mexico, the only case cited of rapid, well-balanced economic growth despite inflationary pressures, the Bank reports that the authorities are now devoting considerable effort to curbing inflation in order to establish a foundation for sounder economic advance.

The Sum-up

The fact is that, however novel the presentation, proposals to use or indulge inflation as an aid to production and growth are not new. They have appeared repeatedly throughout history, been tested, and found wanting. More often than not the experience has ended in a serious setback. It is difficult to escape the New York Reserve Bank's conclusion:

> Economic development through inflation has repeatedly turned out to be a chimera. It is unacceptable as a conscious economic policy. Price stability, as the record shows, is not a luxury that only a few selected countries can afford; nor is it an unattainable goal in a country attempting to achieve a breakthrough that will launch the economy on the road to cumulative economic growth. If it were, there could be no balanced or lasting economic development.
>
> The limitation of general movements in prices is never easy; no single formula to that end has been suggested here. But the effective resolution of any problem, great or small, depends first upon a recognition of the nature of the problem. And the first step in the design of any framework of public policy on economic growth, in the unique conditions of any country, is to recognize that reasonable price stability is not an alternative to economic development but an essential condition for its achievement.

Who Gets the Interest?

The recent round of increases in interest rates has revived discussions as to just who benefits from higher interest and who suffers. From books we read as children we are apt to picture the debtor as a poor breadwinner unable to earn enough to support his growing family. The creditor, on the other hand, is caricatured as a "bloated bondholder" or wealthy banker.

There is not much reality to these conceptions. The banker is not lending his own money but other people's; he is debtor as well as creditor, payer as well as recipient of interest. Banks have more depositors than borrowers. Creditors are more numerous than debtors. The people who borrow have some means because they must prove creditworthiness. All one needs to become a creditor is $1 to open a savings account.

The largest debtor, of course, is government. The Federal Government, excluding agencies, has no less than $290 billion of interest-bearing debt outstanding, not to mention its noninterest-bearing obligations in the shape of circulating notes, and heavy contingent obligations through guarantees of veterans' loans, mortgage insurance, etc. In addition, state and local governments have about $62 billion debt outstanding. Government is a creditor also, but to a much more modest extent. And many of its "loans," as those under farm price-support programs, are extended without obligation of repayment and hence are loans in name only.

Business a Debtor

Business, usually thought of as a major creditor, actually is a debtor on balance. This is

most consistently true for railroads, or for public utilities such as the American Telephone and Telegraph Company whose $250 million bond issue last month raised its funded indebtedness to $2.8 billion. But manufacturers and merchants also float bond issues or borrow from banks, insurance companies, and pension funds.

The table below, drawn largely from Securities and Exchange Commission data, shows the predominantly debtor position of nonfinancial corporations in the United States. These corporations, taken as a group, had on June 30, 1959 total debts of $242.3 billion – $69 billion more than the credits owed to them.

The Nonfinancial Corporation — A Debtor on Balance

(Estimates for June 30, 1959 in Billions of Dollars)

Credits*		Debts	
Cash & bank deposits	$ 35.6	Bond & mortgage debt	$101.2
U. S. Govt. securities	20.0	Term loans	11.8
Accts. & notes receivable	109.1	Accts. & notes payable	82.8
Other	8.3	Federal tax liability	18.7
	$173.0	Accrued payrolls, etc.	32.8
			$242.3

*Excludes physical assets.

Sources: Securities and Exchange Commission, except that corporate bond and mortgage debt and term loans are estimated by this Bank.

Financial institutions are generally thought of as creditors. The average person is aware of them mainly as holders of his mortgage or automobile loan. Financial institutions, however, are intermediaries, middlemen in money. What they lend is owed to others. The creditors of banks are their depositors. Insurance companies accumulate and invest funds for the security and benefit of their policyholders. Pension funds do the same for their beneficiaries, and savings and loan associations for their shareholders. Sales finance and personal loan companies borrow to lend. The networks become complicated: for example, a sales finance company may borrow from insurance companies and banks. The automobile buyer gets his money in the final analysis from policyholders and depositors.

Individual a Creditor

If both government and nonfinancial business are debtors on balance, and financial institutions are intermediaries, it stands to reason that individual citizens are collectively the big creditors. The available statistics on individuals' savings and debt confirm this. If this seems surprising, it is because public attention always focuses on increases in individuals' indebtedness, such as on homes and cars, while largely ignoring the fact that, over the years, individuals' savings have mounted faster than their debts. The figures in the following table indicate that individuals' savings or "credits" totaled $586.7 billion on June 30, more than triple their $186.7 billion debts shown for the same date.

The Individual — A Creditor on Balance

(Estimates for June 30, 1959 in Billions of Dollars)

Credits		Debts	
Life insurance & pension equities	$199.8	Nonfarm home mortgages	$118.1
Time & savings deposits	95.5	Farm mortgages	11.8
Savings & loan & credit union shares	55.3	Other debt of farmers	10.1
Demand deposits	55.2	Instalment debt	35.8
Savings bonds	47.1	Charge acct. debt, etc.	10.9
Other U.S. securities	24.1		
Mortgages	36.3		
Currency	26.2		
State & municipal sec.	25.0		
Corporate bonds & notes	22.2		
	$586.7		$186.7

Sources: Securities and Exchange Commission and other official agencies.

The Federal Government owed individuals $71.2 billion at the end of June 1959: $47.1 billion in the form of Savings bonds and $24.1 billion in the form of marketable U.S. Government securities. The individual is the largest direct recipient of interest paid out by the Federal Government. The distribution of interest paid on the public debt, given in the following table, was submitted by Secretary of the Treasury Robert B. Anderson to the House Ways and Means Committee last June:

Estimated Distribution of the Interest on the Public Debt Fiscal Years 1946 and 1958

(In Billions of Dollars)

	Budget Expenditures	
Investor classes:	1946	1958
Individuals:		
Savings bonds	$ .7	$1.5
Other securities	.5	.4
Subtotal	1.2	1.9
Commercial banks	1.4	1.5
Mutual savings banks	.2	.2
Insurance companies	.5	.3
Nonfinancial corporations	.2	.6
State and local governments	.2	.4
Miscellaneous investors	.2	.4
Federal Reserve banks	.1	.8
Government Investment Accounts	.7	1.5
Total	4.7	7.6

In interpreting this table it should be borne in mind that most recipients of interest on the public debt are subject to federal income tax rates running anywhere from 20 to 91 per cent. In addition, the financial intermediaries, such as commercial banks, mutual savings banks, and insurance companies, are also payers of interest on a large scale to their depositors and policyholders. Interest payments of commercial banks, for example, are on about a par with their receipts of interest on U.S. obligations.

Partly because the Treasury has been denied power to pay more than 4¼ per cent on bonds, it has been forced to finance its huge commit-

ments by sales of shorter-term securities, involving offers of rates running up to 5 per cent. Rates such as these have found their principal appeal among individuals who often have paid for U.S. security purchases by drawing on savings accounts. As a result, many financial intermediaries are experiencing slackened growth, are under pressure to pay higher rates so far as law and financial prudence permit, and find themselves forced to reduce portfolio investments. Increased interest rates are not an unmixed blessing to financial institutions. They create some difficult problems of sustaining lending capacity to meet credit demands of their customers and absorbing losses on security sales.

Tens of Millions of Creditors

How interest payments spread out to individuals all over the United States was indicated by the Federal Reserve's "1959 Survey of Consumer Finances," made early in 1959. The Survey indicated that 50 per cent of all families or spending units in the United States were owners of savings accounts in banks or shares in savings and loan associations and credit unions. Twenty-seven per cent held U.S. Savings bonds. Savings accounts were held by 48 per cent of spending units receiving income of $4,000 to $5,000 a year and by 65 per cent of those in the $6,000 to $7,500 income group. Even down at the bottom of the scale, among spending units with incomes of less than $1,000 a year, 22 per cent had savings accounts. Some, indeed, were living off savings accumulated for old-age security.

The fact is that the creditor in the United States, the recipient of interest, makes up the bulk of the population. Savings accounts in banks numbered 87 million at the end of 1958. Savings and loan association accounts amounted to 24 million and memberships in credit unions 11 million. About 112 million life insurance policies were outstanding; approximately 40 million persons owned U.S. Savings bonds; and 19 million participated in private pension and retirement funds.

Against the background of these figures it is hard to escape the feeling that a good deal of the sympathy one hears for the poor debtor might better be directed to the poor creditor who, until recently, has been ground between the millstones of low interest rates and depreciating money. When one hears prognosticators of creeping inflation advising people to borrow all they can it is hard to justify a conclusion that the creditor is getting excessive pay for trusting the dollar.

The Wider Issue

The real importance of interest rates is not who gets the interest income but how well the interest rate level balances the supply of savings with public and private demand for loan capital. This is the central function of the interest rate, and it is the main reason why rates cannot be kept at artificial levels without the most serious consequences for the economy and people at large.

Interest rates kept at artificially low levels may reduce a saver's income. But far more important is the fact that rates can be held down only by printing money to lend and so watering down the value of all the money and claims for money already in existence. What favored borrowers get is subtly filched from the pockets of the trusting masses of the population.

As Arthur F. Burns, former chairman of the President's Council of Economic Advisers, wrote in his book, *Prosperity Without Inflation:*

> . . . a slow but persistent rise in the price level, to say nothing of stronger doses of inflation, is bound to deal harshly with the plans and hopes of millions of people in the course of a generation. We sometimes overlook the fact that consumers, on balance, are the major creditors of our economy, while the federal government, state and local governments, and business corporations are the debtors.
>
> Holdings of liquid assets, combined with equity in life insurance policies and retirement funds, exceed the indebtedness of every income group of our population. The same is true of every occupational group and of every age group except the newly married. Any increase in the price level therefore reaches into the pocketbooks of the great masses of people and, if it continues for many years, it will impoverish substantial numbers who lack the knowledge or the means for a proper defense against inflation.

A Look Ahead

Higher interest rates reflect the fact that the Administration wants a fair deal for savers and is unwilling to advocate creating more money for the convenience of government and other borrowers. They also reflect the strength of credit demands. From Canada, where rates have risen even more spectacularly, we had a reasoned analysis two weeks ago of why North America is likely to have higher interest rates "as far ahead as it is worth our while to look." Governor James E. Coyne of the Bank of Canada, in a speech in Montreal November 16 said:

> With all governments determined to promote a high level of employment, with many under-developed countries needing to import capital from abroad, with international institutions seeking to increase the flow of such capital and with many national governments also providing capital assistance to various other parts of the world, it is inevitable that the demand for capital will

press upon the annual supply of new savings for years to come, as far ahead as it is worth our while to look.

This means, in my judgment, that we have entered upon a longer period of higher interest rates than those which were prevalent in North America in the depressed thirties, the wartime forties and the early postwar period, although there will be, of course, short periods of moderate reduction in the demand for capital when interest rates will decline.

But under conditions of prosperity in a free society there will always be or appear to be more opportunities for the profitable or useful employment of capital than the amount of capital then available. Should not this be a matter for satisfaction rather than complaint?

A Lesson from Russia

One of the most remarkable facts of the Twentieth Century is the grip taken on Western Civilization by the "heavy progressive income tax" which Karl Marx envisaged as a means of making "despotic inroads on the rights of property, and on the conditions of bourgeois production. . . ."

A second equally remarkable fact is the way Soviet Russia has steered itself away from the booby trap and has thrown aside basic communist doctrine: from each according to his ability, to each according to his need.

In the United States heavy progressive income taxation is justified on the principle of "ability to pay." We can read in an economics best-seller the comforting words that "the income tax, despite high marginal rates and frequent warnings of the damage these may do in impairing incentives, has so far had no visibly deleterious effect."

Premier Khrushchev, on his visit in October, showed greater perception. He frankly pointed out to the President how the U.S. tax system takes away incentives and stifles increased productivity. He remarked that the Russian policy is to provide generous incentives to make people want to work harder. The Soviets found that, without a proportionate reward, the superior man does not put forth the superior effort of which he is capable. Mr. Khrushchev has confidently predicted that their per capita output will exceed that of the U.S. by 1970.

A number of western countries – Germany, Canada, Australia, and the United Kingdom – have broken away from the extremes of personal income taxation. They have also seen the spirits of their people respond to broadened opportunity. But it is the Soviets who have the lightest income tax among major nations. They plan to get rid of it entirely and to pack the whole cost of government into prices paid by consumers.

Few people here would advocate chucking income tax overboard, though it should give us pause that (1) our personal rates reach up to the highest in the world; and (2) we rely on income taxation for an abnormally high proportion of federal government revenues.

Business groups at various times have advocated a low-rate federal sales or excise tax, to shift some billions of tax burden from production to consumption. But no action along this line has been taken. The House Ways and Means Committee is studying the possibility of getting federal income tax rates down and making up the revenue loss by closing so-called tax loopholes. But this approach, while recognizing the way extreme rates develop irrepressible leaks in the tax system, still would leave the bulk of government revenues assessed against work and capital accumulation.

Taxing Progress

Meanwhile, we are still headed the wrong way, layering state income tax levies on top of the formidable federal rate progression. Perhaps we could understand better our failures of growth if we renamed the tax on income a tax on progress.

The idea of leveling everybody out is deplored in *Voprosy Ekonomiki*, official journal of the Soviet Institute of Economics, as "petty bourgeois equalitarianism."* An article on "The Principle of the Personal Incentive" reports that:

> The many years of experience in the organization of social labor under socialism have shown that equalitarianism is incompatible with the interests of the development of socialist production.

The article explains:

> . . . In order to create the abundance of products . . . the principle of personal material incentives to all personnel . . . is of major significance. . . . It is necessary to give industrial and institutional management the right to raise the salaries of persons showing maximum initiative, capacity, and conscientiousness. . . . At the same time it is necessary to improve the system of bonuses to managerial, engineering, technical, and office personnel. . . .

It is encouraging to see these elementary principles of human motivation replacing force and compulsion under state capitalism in the Soviet Union. It would be well for us to take the lesson to heart. And we ought furthermore to remember that a free society is even more dependent upon individual initiative, for capital accumulation as well as work effort.

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*Quoted by Dr. Solomon Fabricant, Director of Research of the National Bureau of Economic Research, speaking on the subject of Productivity at a recent meeting of the Metropolitan Economic Association and the American Statistical Association. English translation from *Problems of Economics*, May 1959, published by International Arts and Sciences Press, New York, N. Y.

Hong Kong, A Success Story

In a free economy, man's ingenuity knows no bounds. The industrial expansion and high living standards of the United States are testimony to what individual enterprise can accomplish. Abroad, too, we find striking examples of what men can achieve when left to solve their own problems.

In Europe, during the years just after World War II, many governments experimented with state planning and economic controls. Over the past decade these have been progressively abandoned or modified. The unleashing of private initiative has enabled the Old World to forge ahead with renewed vigor.

On the other side of the globe is Japan whose remarkable postwar comeback has been due to the hard work and resourcefulness of its people and an economic climate which encourages these energies. Less well known is the case of Hong Kong, Britain's island colony off the South China coast.

Hong Kong's recent economic growth is one of the outstanding success stories in the Far East today. This achievement has been one of private enterprise operating within a free market economy. There has been relatively little government intervention in the Colony's affairs. This is the more significant in view of the challenge to its existence posed by postwar events.

A great seaport and commercial center, Hong Kong grew to prosperity on the entrepôt trade with China, its location convenient for transshipment of goods to and from the West. But when the mainland fell to the communists, and the Korean War brought a United Nations embargo on trade with Red China, all this was suddenly changed. Hong Kong found itself no longer the gateway to China, but instead on the edge of the Bamboo Curtain.

As exports to China dropped from nearly 40 per cent of the total in 1950-51 to a trifling 4 per cent a few years later, and a million refugees nearly doubled its population, Hong Kong searched out other means of livelihood. Instead of massive programs of government spending or requests for foreign assistance, reliance was placed on private initiative.

It was natural for Hong Kong to look to its businessmen in time of crisis. The island was a barren, almost uninhabited rock when it was acquired by the British in 1841 as a trading settlement. Lacking in resources, tillable land, or even adequate water supply, its principal asset is a sheltered deepwater harbor. That it grew and attracted the commerce of all nations was because it offered businessmen – Chinese and Western alike – a stable government, the rule of law, low taxes, and a minimum of official interference.

Enterprise in Action

When necessity forced Hong Kong to find new sources of income to replace the lost China trade, its resourceful businessmen wasted no time. New opportunities were vigorously sought in Southeast Asia. To the recently independent countries of that region Hong Kong offered not just trade but the benefit of its mercantile experience. With inventories of imported goods warehoused locally Hong Kong merchants were able to make rapid deliveries to neighboring countries. Hong Kong's free money market eased the payments problem for many buyers. And its wide range of commercial facilities and duty-free port encouraged foreign companies to maintain regional sales offices there.

Attracted by Asian markets for consumer goods, Hong Kong businessmen were soon drawn to manufacturing as well as trading. Although shipbuilding and some small amount of light industry were already established in the Colony, expansion faced difficulties: lack of fuel, scarcity of industrial sites, and competition from well established foreign producers, not to mention the ever present possibility that the Chinese communists might some day choose to swallow up the little island colony.

But there were assets too. Skilled labor and investable funds were augmented by an influx of refugee labor and capital from the mainland. Most important of all, the economic climate was favorable to enterprise. The colonial government consistently kept its accounts in balance with a standard tax rate of only 12½ per cent on personal and corporate income. Here was opportunity for businessmen to create, to produce, and to enjoy the fruits of their labor.

Industry was expanded and, at the same time, energetic efforts were made to develop larger export markets. New products were introduced and old ones adapted to consumer needs in different countries. The phenomenal four-fold growth of Hong Kong's textile industry, for example, has been due in large measure to skilled marketing – sarongs for the South Seas trade, woolen gloves for European buyers, cheap print cloth for Africa, drip-dry shirts for the United States, cotton knitwear for Southeast Asia, and even made-to-measure suits by mail order.

Impressive Results

In the past decade factory employment has tripled. Despite fluctuations in over-all trade, exports of Hong Kong manufactures have climbed steadily, from a bare 10 per cent of total export sales in 1947 to nearly 70 per cent this year. In value terms this represents a rise from about $40 million to almost $400 million, with more than half comprised of textiles and apparel. Other inexpensive consumer goods make up the balance—kitchen utensils, rubber footwear, flashlights, thermos jugs, and plastic articles.

Production for the local market has grown apace with exports. Food processing and the manufacture of housewares and building materials have increased rapidly. Handicrafts and art objects for the growing tourist trade are another source of income. Hotel and office construction account for a good part of the building boom.

Hong Kong's achievement is all the more impressive since its largest industry — textiles — is the one that meets the stiffest competition in world markets. Hong Kong can compete effectively because its production costs are low. In the absence of exchange controls, its businessmen can buy raw materials in the cheapest market. Since they do not rely on government for expensive services, they pay low taxes. Local labor is industrious and quick to learn. Very little time has been lost through industrial disputes. Although competition has kept wage rates low, the same forces have kept down living costs.

Hong Kong's success in building up its export industries has created new problems. Striking sales gains overseas have brought protests from established suppliers elsewhere. Several nations have placed import quotas on Hong Kong goods. And Red China reportedly has been undercutting Hong Kong sales in some markets by dumping. Despite these difficulties, Hong Kong businessmen are certain they can compete if given a chance. They seek no subsidies or special favors. But they know their future is tied to the healthy growth of world trade. For Hong Kong, freedom to trade is life itself.

Lesson for Underdeveloped Countries

In many parts of the world today governments are seeking to raise living standards through industrialization. To attain this goal, underdeveloped nations have indulged heavily in state planning and other forms of government intervention in economic life. Indeed, it is really quite unfashionable these days *not* to have a development plan.

In seeking to industrialize, governments have burdened their fledgling economies with controls. They have allocated limited resources to ill-conceived projects with resulting inefficiency and waste. Impatient to get ahead in the world, they have fed inflation with printing press money. Exchange allocations, import licensing, and arbitrary taxation have been used to subsidize uneconomic enterprise, eliminate competition, and conceal planning blunders.

For such progress as this, the consumer pays a heavy price. Goods are more costly, selections limited. Foreign investment and private initiative are discouraged. The range of opportunity for local funds is narrowed. The final irony is often the flight of sorely needed domestic capital to more hospitable areas. Hong Kong's postwar industrialization, for example, has benefited not only from refugee money fleeing Red China, but also from the influx of capital from non-communist neighboring countries that could ill afford to lose it.

Hong Kong's success in attracting foreign investment and achieving rapid development despite inherent disadvantages is striking testimony to the truth of liberal economic principles. Of the physical factors usually considered essential to industrial growth, nearly all are missing in Hong Kong. But Hong Kong has offered businessmen greater freedom from official interference than any other area in Asia. It has also provided a stable government and strong support for the free enterprise system. This policy has paid off handsomely by unleashing human potentials that in other countries have remained paralyzed by bureaucratic controls.

Some of the nations now bent on economic advance might well ponder the lesson of this bootstrap operation. Hong Kong's success has also demonstrated that external aid is not the most vital ingredient of a development plan. As the Hong Kong Government itself states in its latest annual report:

> The predominant theme in international discussions about Asia in recent years has been the urgent need for outside assistance . . . to promote . . . economic development and to raise the standard of living. . . .
>
> Hong Kong, however, has [been] . . . the exception. . . . This small Colony, almost entirely lacking in natural resources other than the indomitable will and enterprise of its people, has not only belied all prophecies of economic disaster, but also established itself as a vigorous industrial power. . . . This development has been achieved without major recourse to outside economic assistance . . . and despite formidable obstacles arising from political circumstances beyond local control.

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